



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Parts 5, 200, 207, and 232

**[Docket No. FR-5465 F-02]
RIN-2502-AJ05**

Federal Housing Administration (FHA): Section 232 Healthcare Facility Insurance Program-Strengthening Accountability and Regulatory Revisions Update

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Final rule.

SUMMARY: In 2010 through 2011, HUD commenced and completed the process of revising regulations applicable to, and closing documents used in, FHA insurance of multifamily rental projects, to reflect current policy and practices in the multifamily mortgage market.

This final rule results from a similar process that was initiated in 2011 for revising and updating the regulations governing, and the transactional documents used in, the program for insurance of healthcare facilities under section 232 of the National Housing Act (Section 232 program).

HUD's Section 232 program insures mortgage loans to facilitate the construction, substantial rehabilitation, purchase, and refinancing of nursing homes, intermediate care facilities, board and care homes, and assisted-living facilities. This rule revises the Section 232 program regulations to reflect current policy and practices, and improve accountability and strengthen risk management in the Section 232 program.

DATES: Effective [Insert date 30 days after the date of publication in the Federal Register.]

FOR FURTHER INFORMATION CONTACT: Kelly Haines, Director, Office of Residential Care Facilities, Office of Healthcare Programs, Office of Housing, Department of Housing and

Urban Development, 451 7th Street, SW, Room 6264, Washington, DC 20410-8000; telephone number 202-708-0599 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Relay Service at 1-800-877-8339.

I. SUPPLEMENTARY INFORMATION:

A. Background

Section 232 of the National Housing Act (12 U.S.C. 1715w) (Section 232) authorizes FHA to insure mortgages made by private lenders to finance the development of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities (collectively, residential healthcare facilities). The Section 232 program allows for long-term, fixed-rate financing for new and rehabilitated properties for up to 40 years. Existing properties without rehabilitation can be financed with or without Ginnie Mae®¹ Mortgage Backed Securities for up to 35 years. Eligible borrowers under the Section 232 program include investors, builders, developers, public entities, and private nonprofit corporations and associations. The documents executed at loan closing provide that the borrower may not engage in any other business or activity.

The maximum amount of the loan for new construction and substantial rehabilitation is equal to 90 percent (95 percent for nonprofit organization sponsors) of the estimated value of physical improvements and major movable equipment. For existing projects, the maximum is 85 percent (90 percent for nonprofit organization sponsors) of the estimated value of the physical improvements and major movable equipment.

¹ Ginnie Mae is a registered service mark of the Government National Mortgage Association; see <http://www.ginniemae.gov/>.

As the need for residential care facilities increased, requests to FHA to make mortgage insurance available for such facilities also increased. As with any program growth, updates to regulations are needed to ensure that program requirements are sufficient to meet increased demand, and prevent mortgage defaults that not only impose a risk to the FHA insurance fund but can also jeopardize the safety and stability of Section 232 facilities and their residents. HUD's regulations governing the Section 232 program are primarily codified in 24 CFR part 232.

B. The Proposed Rule

On May 3, 2012, HUD published a proposed rule at 77 FR 26218, in which it submitted, for public comment, revisions to the Section 232 program regulations. On May 3, 2012, HUD also published a notice at 77 FR 26304, which proposed revisions to the related documents used in the insurance of healthcare facilities under the Section 232 program. In the May 3, 2012, rule, HUD proposed regulatory revisions that would update terminology, require a single asset form of ownership, and reflect current policy and practices used in healthcare facility transactions today. The updates included in the proposed rule also included amendments to HUD's Uniform Financial Reporting Standards to include operators of projects insured or held by HUD as entities that must submit financial reports. In addition, in the May 3, 2012 rule, HUD proposed several revisions to strengthen borrower eligibility requirements, as well as HUD's oversight of the healthcare program and projects.

With respect to proposed revisions to the Section 232 documents, published in the May 3, 2012, notice, HUD will address public comments and advise of any changes through separate publication.

C. Key Changes Made at the Final Rule Stage

In response to comments, HUD made several changes to the regulatory text proposed by the May 3, 2012, rule. Key changes made at the final rule stage include the following:

Transition period for compliance. For several of the new or updated regulatory provisions in this final rule, HUD provides a transition period of 6 months before compliance with the requirements become applicable. The final rule, at § 232.1(b), lists which regulatory sections become applicable 6 months after publication of this final rule.

Removal of an across-the-board long-term debt service reserve. The final rule removes the across-the-board requirement, proposed in the May 3, 2012, rule, to establish and maintain a long-term debt service reserve. The requirement was designed to provide a borrower facing operating difficulties, at any time throughout the life of the mortgage, the time to arrange a workout plan by providing a source of funds from which the borrower could make debt service payments and thus delay or avoid an insurance claim by the lender. Several commenters objected to the across-the-board nature of this reserve, and offered various alternatives to provide such additional time for workouts. Commenters recommended addressing the timing issues directly and expanding the time periods involved in a lender's submission of a claim for insurance and HUD's processing of such a claim. This recommendation builds from similar revisions implemented through the updates to the multifamily rental housing program regulations and documents.

This final rule adopts this recommendation. The final rule provides, at § 232.11, that the long-term debt service reserve will be required only in cases where HUD determines a need for such a reserve. HUD anticipates that requiring a long-term debt service reserve will be the exception and not the norm. HUD may require such a reserve when underwriting determines there is an atypical long-term project risk. Atypical long-term risks could occur, for example, in

circumstances in which there is an unusually high mortgage amount, or when some other risk mitigant, such as a master lease structure typically used in a portfolio transaction, is unavailable in a particular transaction.

Removal of requirement for segregation of operators accounts. In the proposed rule, HUD included several provisions requiring the segregation of operator accounts to address the need to isolate a particular healthcare facility's financial transactions from an account where the facility's funds have been commingled with the funds of other facilities. Commenters pointed out that the proposed approach differs from industry practice, is more costly, and is unnecessary in light of available accounting software systems. HUD agrees that accounting software available today is designed to accomplish the interests that HUD identified, and HUD has therefore eliminated the account segregation requirements in this final rule. (See § 232.1013.) Additionally, operator compliance with the new financial reports required under the new 24 CFR 5.801, which was included in the proposed rule and remains in this final rule, will necessitate that the operator maintain accounts in a manner that will allow HUD and the lender to discern the funds attributable to the facility.

Revision of requirement to maintain positive working capital at all times. The proposed rule included provisions that would have required operators to maintain positive "working capital" at all times. In response to commenters' concerns that this requirement is inconsistent with other program obligations, and is infeasible, the final rule addresses working capital, at § 232.1013, by prohibiting the distribution, advance, or otherwise use of funds attributable to the insured facility, for any purpose other than operating the facility, if the quarterly/year-to-date financial statement demonstrates negative working capital. The prohibition remains in place until a quarterly/year-to-date financial statement demonstrating positive working capital is

submitted to HUD. In brief, the final rule provides that HUD will monitor an operator's distribution of funds through its quarterly financial statements to ensure that the facility is positioned to withstand distributions.

Removal of prohibition on payments to borrower principals without prior HUD approval.

The proposed rule provided that no principal of the borrower entity would receive payment of funds (e.g., a salary) derived from operation of the project, other than from permissible distributions, without HUD approval. The final rule removes the prohibition against payment to principals of the borrower without HUD approval (§ 232.1009 at the proposed rule stage), as other sections of the regulations adequately address the issue of circumvention of distribution limitations. For example, § 232.1007 of the final rule requires that the costs of goods and services purchased or acquired in connection with the project be reasonable and reflect market prices, which provides HUD with adequate protection in regard to the level of principals' salaries or other compensation.

Removal of HUD approval of any revisions to management agreements. The proposed rule would have required HUD to approve both initial management agreements, as well as revisions to the management agreements. HUD has determined to retain the requirement for initial approval of management agent agreements, but, in light of the inclusion of the limitation, in § 232.1007, that goods and services be in line with the market, will require approval of only those revisions that are material. (See § 232.1011 of this final rule.)

Removal of HUD approval of any commercial lease or sublease. The proposed rule would have required, at § 232.1013, an operator to obtain HUD approval of any commercial lease or sublease. In response to commenters' concerns that changing industry needs and

practices (e.g., the inclusion of beauty salons in nursing homes) often necessitated leasing and subleasing, HUD has determined to remove the restriction.

Establishing date of default for mortgages insured under Section 232. The final rule clarifies the amendments made to § 207.255 at the proposed rule stage by defining the date of default for Section 232 insured mortgages.

Other changes. In addition to the changes discussed above, the final rule also—

- Provides for flexibility in § 5.801 (uniform financial reporting standards) in the format and manner, as determined by HUD, that financial reports may be submitted to HUD, to the lender or other third party as HUD may direct;
- Adds language to § 200.855, which was inadvertently omitted from the regulatory text but discussed in the preamble to the proposed rule at 77 FR 26222, and that exempted assisted living facilities, board and care facilities and intermediate care facilities from inspections by HUD’s Real Estate Assessment Center (REAC) if the State or local government has a reliable inspection system in place.
- In § 207.258, defines, in paragraph (a) the “Eligibility Notice Period,” adds a new paragraph (a)(4) to provide for acknowledgment by HUD of the lender’s election either to assign its mortgage or acquire and convey title to HUD, and removes language from the opening clause of paragraph (b)(1)(i), which was added in the update of the multifamily project rental regulations, but is no longer applicable;
- Removes the definition of “mortgaged property” in § 232.9 of the proposed rule, as well as the definition section in new subpart F, § 232.1003 of the proposed rule, because these terms are defined in the transactional documents and HUD agreed with

commenters to limit transfer of certain terminology from the transactional documents to the regulations;

- Moves the definition of eligible operator set forth in the proposed rule to a separate regulatory provision at § 232.1003, which establishes the eligibility requirements for operators in the Section 232 program;
- Withdraws the amendments proposed to be made to § 232.251 regarding other applicable regulations, since the final rule addresses this issue in § 232.1.

II. Discussion of Public Comments

The public comment period for this rule closed on July 2, 2012, and HUD received 27 public comments through the www.regulations.gov website. Comments were submitted, through this governmentwide portal, by a wide variety of parties including: commercial mortgage bankers; companies that own, manage, and operate skilled nursing facilities and assisted living facilities; national and state healthcare associations; and a federation of state associations representing nonprofit and proprietary long-term care providers, including nursing and assisted living facilities. Comments were also submitted by a coalition of national investment and mortgage bankers that participate in HUD's healthcare programs, as well as a trade association of lenders and a coalition of national senior residential and healthcare associations. The "HUD Practice Committee" submitted comments on behalf of the Forum on Affordable Housing and Community Development Law of the American Bar Association. Private individuals also submitted comments. As a special outreach to the public on proposed changes to the Section 232 regulations, HUD hosted a forum, the "Section 232 Document and Proposed Rule Forum" on May 31, 2012, in Washington, DC. A video of this forum is available on the HUD internet site at <http://portal.hud.gov/hudportal/HUD?src=/press/multimedia/videos>. While comments were

raised and discussed at the forum, as reflected in the video, HUD encouraged forum participants to file written comments through the www.regulations.gov website so that all comments would be more easily accessible to interested parties. All comments, whether submitted through www.regulations.gov or raised at the forum, were considered in the development of this final rule.

This section of the preamble presents significant issues, questions, and suggestions submitted by public commenters, and HUD's responses to these issues, questions, and suggestions.

General Comments:

Several commenters expressed their general support for the rule as improvements that are necessary and beneficial, stating that the rule provided the appropriate balance of risk mitigation while not overly burdening the borrower and operator or substantially altering demand for the program. Commenters also stated that several of the modifications, such as the limitation on REAC inspections and modification of the borrower surplus cash rules, were beneficial.

Notwithstanding the general support for the rule's objectives, one commenter objected to the rule overall, and other commenters offered suggested changes to several of the rule's provisions.

Comment: HUD's regulatory changes to the Section 232 program will deter participation by third-party operators. A commenter stated that the totality of HUD's regulatory scheme will discourage third-party (non-identity-of-interest) operators from participating in the Section 232 program.

HUD Response: As stated in the preamble of the May 3, 2012, proposed rule, operators now carry out significant day-to-day duties in the administration of healthcare facilities (as

opposed to when the regulations were first promulgated in the 1970s), and this important role needs to be explicitly addressed in regulation. However, while seeking to ensure, through establishment of regulations, the requisite accountability by operators participating in the Section 232 program, it was not HUD's intent to deter participation by responsible operators. In response to public comment, HUD has made several changes at this final rule stage that address concerns that the requirements proposed to be imposed on operators are too stringent.

Comment: Make the final regulations effective as of the date that applications are received. A commenter stated that HUD should make the effective date of the final regulations the date that applications for insurance are received by HUD, rather than the date the firm commitment is issued.

HUD Response: As already discussed in this preamble, the final rule provides a 6-month transition period before compliance with several of the regulatory provisions becomes applicable. Section 232.1 of the final rule identifies the regulatory sections for which HUD provides a transition period but the transition period is linked to the date for which a firm commitment has been issued. Specifically, § 232.1(b) of the final rule provides that the identified regulatory sections will become applicable only to transactions for which a firm commitment has been issued on or after the date that is 6 months following publication of this final rule.

HUD is basing the transition period on the date for which a firm commitment has been issued and not on the date that the application for insurance is received, because significant barriers exist to applying the regulations based on the date for application for insurance. Applications are often less than fully complete when initially received and current program systems lack the capability to determine and memorialize when an application is deemed fully

complete. HUD therefore believes that basing the transition period on issuance of the firm commitment is the correct approach.

Comment: Place program requirements in administrative guidance, not in regulation.

Commenters stated that several executive orders, such as Executive Orders 12866 and 13563, provide that “[F]ederal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling public need.”

Commenters suggested that unnecessary regulations could be addressed by publishing requirements in administrative guidance as opposed to in rules. These commenters suggested that HUD add the phrase “as otherwise permitted or approved by HUD” in various sections of the regulations to provide both industry and HUD with greater flexibility.

Commenters stated that several of the proposed regulatory changes would limit program flexibility with respect to process improvements, such as those recently embraced by HUD, in administering the Section 232 programs and achieved through nonrulemaking documents. A commenter also stated that including the debt service reserve in the regulations is not the “best, most innovative, or least burdensome” method for achieving HUD’s goals.

HUD Response: The regulations provided in this final rule are those that HUD determined are necessary for purposes of updating and strengthening the Section 232 program, and are those which should not, or are likely not to, change frequently. However, as discussed below in responses to comments on specific provisions, HUD has identified certain proposed regulatory provisions, and HUD agreed with the commenters that the provisions did not need to be included in regulation.

Uniform Financial Reporting Standards (24 CFR Part 5; § 5.801)

The proposed rule offered revisions to the reporting requirements of 24 CFR 5.801 to include operators of projects with mortgages insured or held by HUD under the Section 232 program as entities that must submit financial reports. Under current requirements, financial reports are submitted by borrowers, but not operators of Section 232 insured healthcare facilities. HUD had determined that the audited financial statements of a borrower were not sufficient to assess the financial status of a Section 232 project, because the viability of the project is heavily dependent on the operator's financial performance, and the financial statements of the operator should also be reviewed for an accurate assessment of the project's financial status.

The May 3, 2012, rule proposed to retain the longstanding requirement that owners submit audited financial statements annually and proposed to require operators to submit financial statements quarterly, covering separately the most recent quarter and the fiscal year to date.

Comment: Extend the financial report submission deadline. A commenter suggested that HUD should extend the financial report submission deadline in § 5.802(c)(4) from within 30 days of the end of each quarterly reporting period to within 60 days of the end of each quarterly reporting period to provide operators sufficient time to submit required financial information. The commenter also suggested clarifying revisions with respect to the financial reporting requirements that apply when the borrower is also the operator. The commenter stated that the purpose of these suggested changes to the proposed rule was to eliminate duplicative submissions by the borrower and duplicative review by HUD that would result if the borrower were required to submit an annual unaudited financial statement followed shortly thereafter by submission of an annual audited financial statement.

The commenter also proposed that the financial reporting requirements set forth in this section should apply only to those projects that are governed by the new Section 232 loan documents and that received a firm commitment on or after the effective date of final regulations. The commenter suggested revised language in 24 CFR 5.802(d)(4) to limit the application of this section. The commenter stated that without this limiting language, the reporting standards would be retroactively applied to operators of existing insured projects that are not currently subject to these financial reporting requirements under the terms of the mortgage loan transaction documents and regulations in effect at the time the loan closed.

HUD Response: HUD declines to accept the commenter's recommendation to extend the timing for the submission of all reports from 30 to 60 days. Receipt of the unaudited quarterly and year-to-date operator financial statements promptly at the end of each quarter is needed for effective monitoring of a property's financial operations and the trend of those operations. However, in recognition of the intricacies involved in developing year-end financial statements, HUD has extended the submission of the final quarter and year-to-date operator-certified statements submitted for the 4th fiscal year quarter to 60 calendar days following the end of the fiscal year.

Due to the same need for effective financial oversight, HUD also declines to accept the commenter's recommendation to eliminate separate year-end operator quarterly and year-to-date reports when the borrower is also the operator. Operator reports will be submitted in separate systems that allow for more prompt submission than audited reports, and therefore HUD will receive timely and important trend information.

With respect to the commenter's statement that the requirements should be applied only to those projects that are governed by the new Section 232 loan documents and that received a firm

commitment on or after the effective date of final regulations, HUD declines to adopt the change. As stated in the preamble to the proposed rule, HUD determined that the financial statements that HUD currently receives are insufficient to assess the financial status of a Section 232 project. The viability of the project is heavily dependent on the operator's financial performance, and this information is not currently part of financial reports on Section 232 projects. HUD is requiring this information to improve the accuracy of its assessment of a project's financial status, and thus the solvency of the fund. Application of these financial reporting requirements to existing facilities is consistent with authority provided in paragraph 3 of most, if not all of the existing operators' regulatory agreements that provide for the Secretary to request financial reports. This rule implements such a request through regulation. Receipt of these reports will significantly improve HUD's ability to manage and maintain the finances of the FHA insurance fund.

Introduction to FHA Programs: Physical Condition of Multifamily Properties (24 CFR Part 200, Subpart P)

Physical condition standards and physical inspection requirements (§ 200.855)

The proposed rule would have narrowed and streamlined the scope of Section 232 facilities that are routinely inspected by REAC. In particular, the proposed rule provided that facilities such as assisted living facilities and board and care facilities, and properties that are routinely surveyed pursuant to regulations of the Centers for Medicare and Medicaid Services, would not be subject to routine REAC inspections if the State or local government had a reliable and adequate inspection system in place. The remainder of the Section 232 properties would be inspected only when and if HUD determined, on a case-by-case basis and on the basis of information received, that inspection of such facility is needed to help ensure the protection of residents or the adequate preservation of the project.

Comment: Support for the proposed changes. A commenter representing a federation of state associations of nonprofit care providers expressed support for the proposed changes, which the commenter characterized as the REAC multifamily standards, and described such standards as suitable for apartment buildings, but unsuitable for healthcare facilities. Another commenter expressed agreement that facilities should be exempt from the FHA physical inspection requirements on the grounds that the State inspection is thorough and sufficient. The commenter also stated that in addition to the dollars savings outlined in the proposed rule, the exemption would eliminate the conflict between the HUD inspection requirements and the State requirements. The commenter stated that this approach would relieve the facilities of the administrative burden of continually asking for exceptions or waivers to address those conflicts.

HUD Response: HUD appreciates the commenters' support of this regulatory change.

Multifamily Housing Mortgage Insurance (24 CFR Part 207)

Contract Rights and Obligations (Subpart B)

Subpart B of the part 207 regulations addresses contract rights and obligations and the rights and duties of the mortgagee under contract of insurance, and HUD determined that certain revisions were necessary as part of its updating of regulations applicable to the Section 232 program.

Defaults (§ 207.255)

The proposed rule's revisions to § 207.255, "Defaults for purposes of insurance claim," included language defining the date of defaults. The proposed rule would have revised § 207.255(a)(4) by clarifying the dates on which certain monetary and other defaults occur.

Date of Default (§ 207.255(a)(4)(ii))

Comment: Revise the Date of Default. A commenter stated that 24 CFR 207.255(a)(4)(ii) requires revision to take into consideration HUD's ability to prevent the lender from accelerating the debt due to a covenant event of default. The commenter stated that this proposed change is appropriate because the lender is not able to control the time period between when a violation occurs and the date of an assignment.

HUD Response: HUD agrees with the commenter that the Date of Default for a covenant default should not be the date on which the underlying covenant violation occurs, but for reasons different than those advanced by the commenter. In addition, the language in § 207.255(a)(4) is not intended to apply to loans insured under Section 232, and, as stated in the proposed rule, HUD proposed to adjust the language that currently reads “for purposes of paragraph (b) of this section,” to read “for purposes of paragraph (a) of this section.” Therefore, the comment actually relates to the similar language set forth in § 207.255(b)(4)(i), and in response to this comment, HUD is adding § 207.255(b)(5), which applies to mortgages insured under Section 232, to clarify the dates of default applicable to the Section 232 program.

In the final rule, HUD also specifies that a covenant violation does not become a default for purposes of payment of an insurance claim until the lender has accelerated the debt and the borrower has failed to make that accelerated debt payment. Namely, the regulation now provides that for mortgages insured under Section 232, the date of default shall be considered as: (a) the first date on which the borrower has failed to pay the debt when due as a result of the lender's acceleration of the debt because of the borrower's uncorrected failure to perform a covenant or obligation under the regulatory agreement or security instrument; or (b) the date of the first failure to make a monthly payment, which subsequent payments by the borrower are

insufficient to cover when applied to the overdue monthly payments in the order in which they become due.

Section 207(g) of the National Housing Act (12 U.S.C. 1713(g)) provides the authority for payment of a claim for mortgage insurance benefits. Pursuant to that statutory provision, there must be a monetary default in order for the mortgagee to become eligible to receive mortgage insurance benefits. Therefore, the date of default for purposes of payment of a claim, premised on a covenant violation, must be associated with a monetary default. A covenant violation does not become a default for purposes of payment of an insurance claim until the lender has accelerated the debt and the borrower has failed to make that accelerated debt payment. In light of the statutory language and pursuant to HUD's regulation at § 207.255(b), a covenant violation does not become a default until after the mortgagee has accelerated the debt. Accordingly, the date of default referenced in § 207.255(b)(5)(i) should be read to directly correlate to the default referenced in § 207.255(b)(1)(ii); e.g., associated with the acceleration of the debt.

Corrective Change (§ 207.255(b)(3))

HUD did not propose any revisions to § 207.255 in the May 3, 2012, proposed rule. Despite the fact that HUD did not seek comment on this section, one commenter proposed that HUD modify § 207.255(b)(3) to remove the general reference, and limit it to § 207.255(b)(1).

Comment: Revise the references. A commenter suggested that HUD remove the reference to "paragraph (b)" and replace this reference with a more limiting reference to "paragraph (b)(1)". Paragraph (b) of § 207.255 describes the actions constituting a default applicable to multifamily mortgages for which HUD issued a firm commitment for mortgage insurance before September 1, 2011, and for multifamily projects insured under section 232 of

the Act (12 U.S.C. 1715w) and section 242 of the Act (12 U.S.C. 1715z-7). Paragraph (b)(1) provided categories of mortgages covered by the default provisions. In the regulatory revisions of the May 3, 2012, proposed rule, HUD restructured § 207.255 to provide in § 207.255(a) for a “two–tiered” default and in new paragraph (a)(5) for a “grandfathering” of multifamily projects for which firm commitments were issued before September 1, 2011, and for mortgages issued under sections 232 and 242.

HUD Response: HUD is not accepting the suggested change. The revised regulation at 24 CFR 207.255(b)(3) is accurate.

Insurance Claim Requirements (§ 207.258)

The May 3, 2012, rule proposed to modify § 207.258, “Insurance claim requirements,” by further clarifying in paragraph (a)(2) the applicability of the lockout and prepayment premium periods. The May 3, 2012, rule also proposed to modify § 207.258(b)(1)(i) by clarifying the time period within which a mortgagee may elect to assign a mortgage insured under section 232 of the Act to the Commissioner.

Comment: Proposed change to claims process delays payment of the claim. A commenter expressed opposition to the revision to the claims process. The commenter stated that a lender may not file its application for insurance until “HUD acknowledges the notice of election.” The commenter stated that HUD could now delay payment of a claim by refusing to provide acknowledgment of the notice. The commenter stated that this provision undercuts the incontestability of the FHA insurance, as provided in the National Housing Act (12 U.S.C. 1706c(e)), by implementing a practical barrier to the realization of the lender’s insurance benefits. The commenter stated that this requirement allows HUD to deny benefits to a lender even though the lender has followed all claims processing requirements.

HUD Response: HUD declines to accept the commenter's recommendation. The imposition of a waiting period does not undercut the incontestability of the FHA insurance, as suggested by the commenter. Receipt of FHA insurance benefits is not instantaneous, because certain procedures must be followed. Where there have been delays in a lender's receipt of insurance benefits or rejections of a lender's claim, it is HUD's experience that such outcomes were due to the lender not meeting program requirements; for example, impermissible liens on the property having not been resolved.

Mortgage Insurance for Nursing Homes, Intermediate Care Facilities, Board and Care Homes, and Assisted Living Facilities (24 CFR Part 232)

Nomenclature Change

In its review of the regulations in 24 CFR part 232, HUD noted that the regulations use both the terms "borrower" and "mortgagor." These terms have the same meaning, and to avoid any misunderstanding that they have different meanings, the May 3, 2012, rule proposed to substitute the term "borrower" for "mortgagor" throughout the part 232 regulations. That said, the healthcare financing and transactional documents for the Section 232 program may sometimes refer to the borrower as the "mortgagor," "lessor," and/or the "owner."

Eligibility Requirements (Subpart A)

Eligible borrower (§ 232.3)

The May 3, 2012, rule proposed to revise the definition of eligible borrower to provide that the borrower shall be a single asset entity, determined acceptable to the Commissioner, and that possesses the power necessary and incidental to be operating the project. The proposed rule also provided that the Commissioner may approve an exception to this single asset requirement in limited circumstances based upon such criteria as specified by the Commissioner.

HUD identified one error in the proposed rule definition. Rather than stating “incidental to operating the project,” HUD intended to state “incidental to owning the project,” and this change should address several of the concerns by commenters about the definition of borrower, as discussed below.

Comment: Modify requirements for single asset entities to address identity-of-interest issues for operators. A commenter stated that the proposed rule would hamper workouts by limiting the number of potential operators that can assume responsibility for the operations of a facility. The commenter stated that the proposed rule would cause significant time and cost burdens on the State licensing agencies that will be required to address the changes of owners and operators on HUD transactions. Commenters also stated that the requirement should be limited to new construction and acquisitions and not be applicable to refinancing transactions. Commenters stated that under the current regulatory regime, operators typically could operate a number of different facilities and own separate properties in the name of the operator. Commenters stated that requiring operators to be single asset entities means that many operators would need to either: (i) transfer operations at the project level (including licenses and provider agreements) or (ii) transfer other assets, including licenses and interests in other facilities, all of which can be time consuming and expensive. The commenters stated that particularly where there is no identity of interest between the owner and operator, the operator may be unwilling to transfer property to comply with HUD's single asset requirements.

HUD Response: HUD recognizes the concerns raised by the commenters about single asset entities but believes that the language in the proposed rule, as modified by the correction of “operating” to “owning” in this final rule, gives adequate flexibility in this respect, and therefore HUD declines to adopt the commenters’ recommendations. The proposed rule language in 24

CFR 232.3 explicitly authorizes HUD to approve "a non-single asset entity under such circumstances, terms and conditions determined and specified as acceptable to the Commissioner." In addition, the proposed definition of operator provides the same flexibility for the Commissioner to specify non-single asset entities. The final rule retains this explicit authorization and flexibility. However, HUD has removed, in this final rule, the separate effective date for the implementation of this particular section. There is no overriding need for a phase-in requirement because the flexibility provided to the Commissioner to allow non-single asset entities in the rule language can be exercised where necessary.

Establishment and maintenance of long-term debt service reserve accounts (§ 232.11)

The proposed rule provided that to be eligible for insurance under the Section 232 program, and except with respect to the regulatory provisions applicable to supplemental loans to finance purchase and installation of fire safety equipment (24 CFR part 232, subpart C), the borrower must establish, at final closing and maintain throughout the term of the mortgage, a long-term debt service reserve account.

Comment: Eliminate or modify the long-term debt service reserve. Commenters stated that requiring establishment of a long-term debt service reserve inappropriately restricts funds, is unnecessary for well-capitalized and well-performing properties, and is inconsistent with the practices of private lenders. Commenters stated that there are a number of problems with this proposal, which are outlined as follows.

Commenters stated that the cost of the required extra capital far exceeds the small amount of interest one earns when investing in the loan servicing account, given the cost of capital and the interest earned on the funds deposited. Several commenters stated that this would add incremental costs that would make the program noncompetitive with Fannie Mae, Freddie Mac,

and the Rural Housing Service of the U.S. Department of Agriculture (USDA), commercial banks, and finance companies. A commenter further stated that this requirement defeats the purpose of the mortgage insurance premiums (MIP), which is already equivalent to an approximate 15 percent premium on the stated rate of interest. Commenters also stated that the proposal would contribute to adverse selection of FHA borrowers that would deprive FHA of the benefit of MIP payments on higher-quality lower-risk transactions.

Commenters also stated that the debt service reserve would not reduce the number or severity of mortgage insurance claims. Commenters stated that the requirement as proposed would be imposed on all properties whether or not they are well capitalized or are well performing. Commenters further stated that the debt service reserve was unnecessary, in particular, for those projects included in a master lease structure as that structure: (1) results in all project funds being available to service the debt of a struggling project, and (2) provides a strong incentive to the operator to support the struggling project. The commenters also stated that under conventional loan standards, impositions of a debt service account are limited to under-performing loans.

Commenters further stated that maintaining a minimum balance throughout the life of the loan greatly extends the amount of time a borrower must restrict funds for this purpose.

Commenters stated that debt service reserves should not be required for § 223(a)(7) (refinancing) loans because, in refinancing, the borrower will: (1) reduce debt service costs, increase the debt service coverage ratio, and increase funding of the reserve for replacement and/or the completion of necessary repairs, and (2) will not have mortgage proceeds available to fund the debt service reserve because they are limited by the amount of the original insured mortgage.

Commenters stated that HUD should modify § 232.11 to state that the long-term debt service reserve would be required at the discretion of HUD.

Several commenters also provided suggestions on how HUD may implement the long-term debt service reserve, if HUD chose to retain this requirement at the final rule stage. These suggestions include the following:

- The lender, not HUD, should recommend the reserve as part of the application for insurance and minimal reserves should be allowed for strong projects.
- The date of establishment of the debt service reserve should be flexible, rather than requiring the reserve to be established by the date of final closing.
- The entire reserve should be mortgageable even if the reserve results in a mortgage over the 80 percent loan-to-value (LTV) created during the conversion to Section 232 program financing. Commenters stated that this is common in the industry as cash secured lending is dollar for dollar and does not affect the collateral position. A commenter stated that HUD should allow the debt service reserve to be included as an eligible cost up to the 85 percent level.
- Flexibility should be allowed in the release of such reserves. Commenters stated that it is difficult for a borrower to agree to “HUD’s sole discretion.”

Commenters stated that rights must be given to the lender and that the lender can use its discretion on release of reserves. Also, commenters stated that there should be some benchmarks that allow the borrower to tap into the funds such as: (a) a debt service coverage ratio (DSC) that is below 1.0 for some period of time or (b) a certain threshold of capital the borrower must have contributed before the reserve can be tapped.

- Use of the Master Lease agreement should be eliminated or reduced if a longer debt service reserve is established.
- Extend the time that HUD can require a lender to advance mortgage payments from 90 days to 180 days (multiple commenters made this comment).
- Allow borrowers, with lender approval, to consider funding the reserve with letters of credit.
- Establish the reserve in a handbook as opposed to a regulation.
- Remove the “long-term” qualification.

Commenters suggested that alternative strategies would have similar results. These included:

- Require debt service reserve payments under certain events such as a DSC below 1.0 or negative working capital with the reserve to be released and/or suspended upon some threshold of DSC being met.
- Require a debt service reserve payment in the event of a default of the regulatory agreement or of any pertinent loan document.
- Require the servicer to make debt service payments for some period of time before or otherwise extend the time before servicers can assign the mortgage to HUD, which the commenters stated would encourage servicers to implement early warning and workout strategies.
- Build in additional flexibility by, for example, adding language to give HUD the flexibility to allow for a reduction in the minimum balance required to be maintained in the debt service reserve and to allow for the release of funds in the debt service reserve in excess of the required amount.

HUD Response: HUD accepts the commenters' recommendations in part, and is modifying the language establishing the long-term debt service reserve in two major respects. First, the final rule modifies the proposed rule to provide HUD with the discretion as to when a long-term debt service reserve may be necessary. Second, the final rule provides for extensions of the time periods involved in the claims process, set forth in § 207.258, prior to the mortgagee's assignment of a mortgage to HUD, in order to provide HUD the same protection as was intended by the proposed long-term debt service reserve. Namely, such extensions to the claims process provide time and space for the parties involved to attempt a workout.

Because HUD does not intend to require long-term debt service reserves across the board, there is no need to address the issue of refinanced loans. HUD anticipates that the use of a long-term debt service reserve will be rare (unlike the short-term debt service escrow account that has been frequently used in the Section 232 program, and which is not a mortgageable item). HUD envisions that a long-term debt service reserve will be necessary in circumstances in which underwriting indicates an atypical long-term risk. Examples of circumstances in which HUD may require the establishment of a long-term debt service reserve include an atypically high mortgage amount, or if a key risk mitigant (such as a master lease structure typically used in a portfolio transaction) is unavailable.

HUD declines to accept some of the commenters' recommendations, such as waiting to establish the long-term debt service reserve when the need arises, as such an approach would be imposed too late to serve a useful financial purpose. HUD has also determined to retain the "long-term" qualification to distinguish these accounts from short-term escrow accounts. HUD also determined to retain the minimum balance requirement contained in the proposed rule to assure that reserve funds are not diverted and are used for the intended purpose.

Contract Rights and Obligations (Subpart B, Part 232)

Subpart B of the part 232 regulations addresses contract rights and obligations and the rights and duties of the mortgagee under the contract of insurance. The May 3, 2012, rule proposed several changes to the subpart B regulations.

Withdrawal of project funds, including for repayments of advances from the borrower, operator, or management agent (§ 232.254)

The proposed rule would have added a new § 232.254 to provide that borrowers may, to the extent allowed in their transactional loan documents and applicable law, make and take distributions of mortgaged property under certain conditions. The proposed rule also included a definition of surplus cash.

Although previously, the borrower could take distributions only annually (or, in limited circumstances, semi-annually), the proposed rule would have allowed borrowers to take distributions more frequently, provided that, upon making a calculation of borrower surplus cash, no less frequently than semi-annually, such borrowers can demonstrate positive surplus cash in their semi-annual surplus cash calculation or repay any distributions made during the fiscal period if a negative surplus cash position is shown. HUD included language in the proposed rule to clarify that it does not intend to override existing transactional agreements.

Comment: Remove the 30-day repayment limitation. A commenter stated that it is unnecessary to include a specific time period in the regulations for repayment of disbursements taken during a negative surplus cash period. The commenter stated that paragraph 16(d) of the “Healthcare Regulatory Agreement — Borrower” (HRA-B) document includes provisions on repayment, and in the interest of promoting flexibility in the regulations, the commenter proposed a revision. The commenter suggested the following: "30 days or within such shorter

period as may be required by HUD", be replaced with "within such time period as may be specified by HUD."

HUD Response: HUD adopted the concept of the commenter's recommendation. The final rule clarifies that borrowers will receive a minimum of 30 days, but HUD has the discretion to approve a longer time period, which will provide additional flexibility when a facility or project is in a workout situation.

Comment: Revise definition of "surplus cash" to include cash and cash equivalents and exclude amounts payable from escrows. A commenter suggested that the definition of surplus cash be revised to be consistent with paragraph 15 of the proposed HRA-B document. The commenter suggested that the definition of surplus cash in the regulations should include cash and cash equivalents (i.e., short-term investments), less the payment and segregation of amounts as thereafter set forth in 24 CFR 232.254(b).

The commenter further stated that when calculating surplus cash, accounts receivable and accounts receivable financing should either: (1) both be included in the calculation, or (2) both be excluded from the calculation. The commenter stated that the best way to address this issue would be to exclude as a deduction any accounts receivable financing approved by HUD and to exclude accounts receivable from cash. The commenter stated that its proposed approach is the more conservative option as, due to the borrowing base requirements, the accounts receivable will be higher than accounts-receivable financing, so including it in the calculation would create more surplus cash than the method of calculation that HUD proposes. The commenter stated that its proposed approach would also be more consistent with normal and past experience, and has the additional benefit of being easier to administer because it does not require a determination of the age of accounts receivable, whether the accounts receivable are collectable or similar types of

information.

A commenter suggested excluding the "amounts payable from escrows held pursuant to the mortgage" from the calculation of "all other accrued items payable by Borrower," to avoid double counting.

HUD Response: HUD understands the commenter's concerns, and appreciates the comments submitted regarding the calculations involved in a determination of surplus cash. Given the commenter's concerns about the components of this calculation, and the effect that changes to the definition would have on distributions, the final rule removes this definition from the regulatory text. The term surplus cash has historically been defined in the borrower regulatory agreement, and HUD will retain the definition in that document.

Leases (§ 232.256)

The proposed rule would have added a new § 232.256 to require that a borrower may not lease any portion of the project or enter into any agreement with an operator without HUD's prior written consent.

Comment: Section is overly onerous and ineffective. Several commenters stated that inclusion in the regulations of the requirement to obtain HUD approval prior to entering into leases is unnecessary, and suggested removal of this section in its entirety. Commenters stated that, historically, HUD has regulated operating and commercial leases through the terms of the Regulatory Agreement. The commenters stated that, therefore, imposing limits on leasing of the project is adequately addressed through existing mechanisms. Commenters further stated that although the multifamily regulations were recently updated, there was no analogous limitation with respect to leases in the recently adopted regulatory changes.

Commenters also stated that if HUD did not accept the suggestion to remove the requirement in its entirety, HUD should consider revisions that would add necessary flexibility to the regulation, such as giving HUD the ability to categorically permit certain types of leases across all projects through “Program Obligations,” a concept expressed in the discussion of HUD’s recent May 2011 rule on multifamily rental projects and in the notice advising of document changes to the multifamily rental project documents. Alternatively, commenters suggested that HUD approve project-specific leases on a case by-case basis.

HUD Response: HUD accepts the commenters’ recommendations and has removed this section.

Maximum Mortgage Limitations (§ 232.903)

Section 232.903 describes the maximum loan to value limits and the specific items that can be included as mortgageable items.

Comment: Include limits for public entities in § 232.903. A commenter suggested an addition to the existing regulation at § 232.903 to address public entity borrowers. Although this provision was not addressed by the proposed rule, the commenter suggested revising the existing regulatory language to add reference to public entity borrowers. The currently codified § 232.903 specifies the limits that apply to profit-motivated borrowers and private nonprofit borrowers, but does not address public entity borrowers, which are a class of borrowers contemplated in the Regulatory Agreement.

HUD Response: HUD declines to accept the commenter’s recommendation. A suggested change was not proposed in the May 3, 2012, rule, and the commenter did not provide specific examples of the types of borrowers that would be covered by this term. Although HUD

is not adopting the commenter's suggestion for this rule, HUD will give further consideration to the proposal.

Comment: Revise project-refinancing limitations in order to account for a change in ownership. A commenter stated that new § 232.903(c)(1)(i) (which addresses refinancing by an existing owner) prohibits a change in ownership, without specifying any time limitations as to when the change in ownership is prohibited from occurring. The commenter suggested adding the phrase "subsequent to the date of application" to this provision.

HUD Response: HUD accepts the commenter's recommendation and has included this language in the regulation.

Comment: Revise the cost to refinance in § 232.903(c). A commenter suggested that while HUD revised the paragraphs providing a description of existing indebtedness, those mortgageable items should more appropriately be included in the costs to refinance.

HUD Response: HUD appreciates the commenter's recommendation and agrees that these costs are appropriately listed as costs to refinance. HUD accordingly adopts the commenter's recommendation and has revised the regulation to address this issue.

Changes to § 232.903(c) and § 232.903(d) are needed to clarify proposed references to long-term debt service reserve. In this final rule, HUD revises § 232.903(c) and § 232.903(d) to improve clarity by providing a cross-reference to the long-term debt service reserve in § 232.11. HUD further clarifies that the debt service reserve contemplated by this final rule is "long-term" and added this qualifying term in §§ 232.903(c)(2)(vi) and 232.903(d)(6). These changes are intended to eliminate any potential confusion between this reserve and a short-term escrow. HUD is allowing the long-term debt service reserve to be a mortgageable item. The traditional short-term debt service escrow account has always been funded by the mortgagors themselves

and is therefore not a mortgageable item. Examples of short-term debt escrow include the escrows on new construction/substantial rehabilitation projects, or escrows established because a project may lack a lengthy adequate financial history. Such short-term escrows have a separate escrow agreement.

Comment: Revise the cross-reference to Mortgagee Fees (§ 232.903(c)(2)(iii) and (d)(3)).

A commenter stated that § 232.903(c)(3) and § 232.903(d)(3) contain cross-references to "mortgagee fees under § 232.15". The commenter further stated that there is no § 232.15 in the current regulations. The commenter suggested that the revised regulation could reference § 200.41, Maximum Mortgagee Fees and Charges.

HUD Response: The commenter is correct and the cross-reference to 24 CFR 200.41 has been added.

Eligible Operators and Facilities and Restrictions on Fund Distributions (New Subpart F)
Definitions (§ 232.1003 in proposed rule – removed in final rule)

At the proposed rule stage, HUD defined the following terms in a proposed new § 232.1003: identity of interest, management agent, operator, owner operator, and project. On further consideration, HUD determined that the term “operator” in proposed § 232.1003 established Section 232 eligibility requirements for operators more than simply providing a definition for this term. With respect to the remaining terms, all of which are addressed in the transactional documents, HUD is removing these terms from the regulations, agreeing with commenters that the better location for these terms remains the transactional documents. Therefore, § 232.1003 at this final rule addresses eligible operators only.

Although the final rule removes the definition section for new subpart F of part 232, several comments were submitted on the proposed definitions, and HUD responds to these comments below.

Single Asset Entity

Comment: “Operator” as a single asset entity is unworkable. Commenters stated that although many organizations have adopted the single asset structure, it is very common for a single legal entity to act as operator for multiple facilities. Commenters stated that segregating operations is a time-consuming process due to the need to transfer multiple licenses, establish new bank accounts, and revise numerous legal documents and agreements, and that these are particularly time consuming issues for facilities that are managed by national chains for a single asset borrower. Another commenter stated that, in some states, the single asset entity operator requirement would trigger the need for the healthcare facility to obtain a new Certificate of Need. Commenters stated that all of these changes, and the costs associated with them, make the alternative unworkable and unattractive.

Other commenters stated that the single asset entity operator be recommended but not required. Commenters also recommended that the existing organizational structure remain in place in refinancing, given that such a structure is difficult to unwind.

HUD Response: The definition of operator in the proposed rule provided flexibility for the Commissioner to approve non-single asset entities, and HUD retains that definition in the final rule.

In reviewing its portfolio of healthcare loans, HUD found that a large number of the operator entities in the Section 232 program are, in fact, single asset entities—for prudent business purposes not necessarily related to FHA-insured financing. The approach of these

operator entities is also helpful to HUD's effort to assure that the operator's viability and accountability is not adversely affected by the operation of other businesses (as in the case, for example, of bankruptcy or other litigation). Nevertheless, HUD recognizes that there are operating entities in the industry that successfully operate multiple facilities without facility-specific operating entities. HUD did not intend to impede this practice where it is effective, and therefore, the proposed definition of "operator" also explicitly authorized HUD to approve "a non-single asset entity under such circumstances, terms and conditions determined and specified as acceptable by the Commissioner."

In § 232.1003 of this final rule, which now only addresses eligible operators, HUD retains this language from the proposed rule and anticipates that in situations in which licensure or other issues make utilizing a separate operating entity problematic, a non-single asset operating entity will be approved.

Operator

Comment: Specify that a master tenant is not an operator. Some commenters expressed concern that a single asset form of ownership was particularly inappropriate where Master Leases are concerned. A commenter stated that in some instances, a single project may have multiple operators. For example, a project may have a separate operator for each of the skilled nursing and assisted-living portions of a single healthcare campus. Additionally, the commenter stated that it should be specified that a master tenant is not an operator, as master tenants are not operators once they sublease the property to operators under HUD-approved subleases.

Other commenters stated that the requirement for operators to be single asset entities is a significant change. They stated that they do not object to the language as proposed, because it provides appropriate flexibility for HUD to approve non-single asset entities. The commenters

requested, however, that, prior to issuing further guidance in the form of a handbook or otherwise, there should be a conversation between HUD and the healthcare industry, as there are many situations in which it may not be possible or appropriate to have a single asset operator.

HUD Response: With respect to the master lease issue, HUD clarifies in this final rule that, in a master lease context, the term “operator” refers to an entity that operates a facility (generally the sublessee).

With respect to establishing dialogue with industry on regulatory and transactional document changes in the Section 232 program, HUD has a good record of reaching out to industry for its input, first in the context of updating the multifamily rental project regulations and transactional documents, and now in the updating of the Section 232 program regulations and transactional documents. HUD plans to continue with such outreach.

Comment: Define arms-length or “third-party operator” to allow the inclusion of real estate investment trusts (REITs) and private investors. A commenter stated that the lack of a definition for an “arm’s length” or “third-party” operator, together with a set of new provisions that considers the unique characteristics of this ownership group, will limit participation in the Section 232 program of one of the largest and fastest growing ownership types that include REITs and private investors. The commenter recommended that the final rule include a definition of these terms.

HUD Response: HUD declines to adopt the commenter’s recommendation. HUD is interested in addressing the issues raised with regard to REITs and private investors, and received detailed comments with respect to this issue on proposed changes to the transactional documents. HUD will further consider these issues in the context of the documents.

Comment: Provide how HUD will define identity of interest. A commenter noted that HUD included a definition of “Identity of Interest Project” in the proposed rule, but did not include a definition of “identity of interest” nor does the currently codified regulations define this term. The commenter further stated that HUD defined an identity of interest in the Regulatory Agreement, but this definition was not clear because it uses the term "ownership entity," which is also not a defined term, and the term "borrower" is used everywhere else in the agreement. The commenter requested that HUD clarify the meaning of identity of interest.

HUD Response: HUD declines to accept the recommendation. As noted earlier in this preamble, at this final rule stage, HUD is removing the proposed definition section from subpart F, agreeing with commenters to address terminology in the transactional documents.

Treatment of project operating accounts (§ 232.1005)

Proposed new § 232.1005 addressed commingling of funds and directed that an operator must not, without HUD’s prior approval, allow funds attributable to an FHA-insured or HUD-held healthcare facility to be commingled with funds attributable to another healthcare facility or business. This section also directed that funds generated by the operation of the healthcare facility are to be deposited into a federally insured bank account in the name of the single asset operator of the facility.

Comment: Allow HUD discretion to modify deposit-of-funds requirements. A commenter stated that for HUD to have flexibility to address situations in which accounts receivable financing or other arrangements support the deposit of funds in a manner other than into a separate, segregated account or to respond to changes in technology, the following language should be added to the funds deposit requirement: "except as otherwise permitted or approved by HUD."

The commenter also suggested removing "single asset" where it appears in this section. The commenter stated that even if the operator is a single asset entity, funds must still be held in an account in the name of the relevant entity, and if HUD waives the single asset entity requirement for either an owner or operator, that waiver should not impact the requirement that project funds be segregated.

HUD Response: In this final rule, HUD adopts the commenter's recommendation to allow flexibility for funds to be deposited in accounts other than under the name of the operator. HUD also adopts the commenter's recommendation to remove the reference to the single asset operator in this section. There is no need to include the qualification of single asset entity given that it is addressed in § 232.1003 (eligible operator) of the final rule.

Comment: Remove reference to "funds generated by the operation of the healthcare facility." "A commenter suggested that HUD remove the reference to the phrase "funds generated by the operation of the healthcare facility" in the description of funds deposited because the phrase is overly broad.

HUD Response: HUD declines to adopt the suggestion. HUD finds the reference to funds generated by the operation of the healthcare facility to be accurate and appropriately located in the rule. In addition, the inclusion of the new language ("except as otherwise provided by HUD") provides HUD with the authority to make any adjustments, as HUD may determine necessary. However, in this final rule, HUD removes language that could be interpreted as limiting the requirement that owner's project related funds be deposited into a federally insured bank account in only those situations where the borrower is not also the operator. Removal of that clause is intended to clarify that all of an owner's project-related funds must be deposited into a federally insured bank account in the name of the borrower.

Comment: Restriction on comingling of funds is unworkable. Commenters stated that the restriction on comingling of funds is in conflict with typical accounts receivable financing, and is not supported by the cost-benefit analysis. Commenters suggested that industry costs do not outweigh benefits. A commenter stated that the requirement that "funds generated by the operation of the healthcare facility" be deposited into an account in the operator's name is problematic as it has the potential to cause funds that are not attributable to the operator to be deposited in the operator's account. The commenter stated that a single project may have multiple operators. The commenter further stated that funds paid to the borrower as rent under an operating lease are arguably "funds generated by the operation of the healthcare facility," but that they should not be deposited into the operator's bank account. The commenter suggested changes to correct what the commenter characterized as unintentional over-breadth of the language in the proposed rule.

Commenters suggested that HUD recognize industry best practices by requiring the lender's underwriter to review the operator's accounting system to ensure that the project has an annual audit with property level accounting. The lender would review the operator's procedures (i.e., monthly bank reconciliations) to ensure the protection and accurate tracking of cash. Commenters also urged HUD to remove the prohibition against comingling operator's funds as interfering with the implementations of the master lease program and accounts receivable financing and use concentration accounts. The commenters recommended that HUD use the control account agreements to stop funds moving into a concentration account if the project is in financial trouble.

Several lender commenters suggested that, as part of the underwriting, the lender or a consultant retained by the lender be required by HUD to perform an analysis of an operator's

accounting systems to determine that the systems are sufficiently sophisticated to produce financial statements on a facility-by-facility basis.

HUD Response: As noted earlier in this preamble, in this final rule, HUD removes the requirement for segregation of operator accounts. For the reasons discussed earlier in this preamble, HUD determined that the availability today of sophisticated accounting software has the ability to protect HUD and the lender's interest without necessitating the segregation of accounting.

Comment: Proposed working capital requirements are unworkable. Several commenters stated that the requirement to maintain positive working capital in order to use funds to pay nonproject expenses without advance written HUD approval is not workable. Some commenters stated that such requirement becomes an additional surplus cash requirement.

A commenter voiced opposition to any working capital requirement, and stressed the importance of looking at an operator's portfolio in the aggregate. Another commenter asked if HUD intended to apply the working capital rules retroactively. A commentator stated that HUD should not impose this requirement at the operator level because doing so would limit the ability to efficiently manage cash at the multiprovider level.

Commenters also stated that establishment of a working capital fund would make operators and owners the targets of litigation, and that owners and operators would therefore need to limit exposure by limiting the amount of cash available to the operating entity as well as to the parent entity.

Commenters further stated that this proposed requirement was not acceptable to any operator subject to a master lease. A commenter stated that there are occasions when a facility will encounter operational issues and could end up in a negative working capital position. The

commenter stated several acceptable reasons to have a negative working capital position, namely that the project: (1) was in turnaround, (2) had decreased occupancy to allow renovations, (3) was new construction and working toward positive capital, and (4) was in compliance with state law, spending significant resources to maximize future reimbursements.

A commenter stated that if the requirement were to be put into place, the current assets, including accounts receivable, and current liabilities, such as accounts payable of the same time period, should be included in the calculation. The commenter further recommended that any current portion of long-term debt that is to be refinanced in the normal course of business be removed from the calculation because inclusion makes it punitive. Another commenter offered recommendations to HUD with respect to working capital, which included the following:

- Establish a “carve out” for any accruals of contingent liabilities or liabilities under appeal (such as malpractice award accruals for civil money penalties under appeal);
- Exclude from the calculation of current assets and current liabilities any payables to ownership for advances and any payables to the management company or affiliates for services rendered;
- Allow the facility to have negative working capital for at least 2 consecutive fiscal quarters before negative impacts are imposed on the borrower or operator; and
- Clarify that healthcare facility working capital relates solely to the operator.

HUD Response: HUD is removing proposed rule § 232.1005(c) and modifying proposed rule § 232.1017(b) (§ 232.1013 in this final rule). The revised provisions in the final rule tie HUD oversight of working capital, including calculation of working capital and restrictions on withdrawal, to the quarterly financial reporting system. This rule does not define working

capital, but HUD will take into account the commenters' suggestions regarding the calculation of working capital when revising the Operator's Regulatory Agreement.

Comment: Reference the mortgage loan transactional documents in positive working capital. A commenter proposed that the final rule provide a reference to the mortgage loan transactional documents. The commenter stated that the rule should provide that positive working capital requirements will be governed by the proposed Healthcare Regulatory Agreement — Operator document. Another commenter raised an issue relating to perceived conflicts in the document requirements. The commenter stated that there are conflicts between this definition and the proposed Master Lease Addendum and others of the Mortgage Loan Documents, specifically, in the regulatory agreements, in which "working capital" would generally be defined.

Other commenters stated that the concept of maintaining positive working capital (which was originally in the proposed rule at § 232.1005(c)), was not defined, and absent a definition specifically including accounts receivable (AR) financing loan proceeds as an asset in the working capital calculation, no project with AR financing would ever be in a positive working capital situation.

HUD Response: HUD determined that it was not necessary to include a definition of working capital in the regulations because, as the commenter notes, this term is already addressed in the Section 232 transactional documents. In its review of the documents, HUD will further evaluate the use of the term "working capital" to determine whether there are potential conflict issues.

Operating Expenses (§ 232.1007)

The proposed rule would have required that goods and services purchased or acquired in connection with the project be reasonable and necessary for the operation or maintenance of the project, and the costs of goods and services incurred by the borrower or operator to not exceed amounts normally paid for such goods or services in the area where the services are rendered or the goods are furnished, except as otherwise approved by HUD.

Comment: The requirement to ensure that goods and services are reasonable and necessary and do not exceed prices normally paid in the area is impossible to define and monitor.

Commenters stated that this provision should be removed as it is contrary to their need to make good business decisions, many of which are driven by qualitative factors not entirely related to cost, while being flexible and fluid to meeting the dynamic nature of the senior-living business. Commenters also stated that it would be impossible to monitor and define.

HUD Response: HUD declines to adopt the commenter's recommendation. HUD is modifying or removing various other more specific provisions regarding expenses that were included in the proposed rule (e.g., the definition of identity-of-interest management agents and limitations on payments to principals), on the basis that this provision is sufficient. HUD has determined that this provision essentially sets forth a reasonable business practice standard. HUD recognizes that a multitude of factors may affect the value of particular goods or services for a particular buyer, and this provision is not intended to constrain a party from considering the many aspects relevant to a purchase. HUD does not intend to micromanage individual purchase decisions. However, when and if an owner or operator's financial performance at the facility becomes problematic, HUD could legitimately act to protect its interests, including by reviewing the reasonableness of project goods and services, and by taking of any enforcement actions that may be warranted.

Comment: Provide HUD with flexibility to permit variations. A commenter suggested inclusion of the phrase “permitted” to allow HUD to provide additional guidance on this standard.

HUD Response: This final rule adopts the commenter’s recommendation.

Payments to borrower principals prohibited (§ 232.1009 in proposed rule - removed in final rule)

The proposed rule provided that no principal of the borrower entity may receive a salary or any payment of funds derived from operation of the project, other than from permissible distributions, without HUD’s prior approval.

Comment: Restrictions on payments to Principals/Affiliates are too onerous. Several commenters objected to this provision and stated that the restrictions penalize family-oriented owners/operators, affiliates of borrowers or entities with an identity of interest, and operators that provide ancillary services to their facilities through an affiliate strategy. Commenters recommended permitting principals or those with an identity of interest to receive market salaries without HUD interference. They also suggested that HUD remove the ancillary business restrictions.

Commenters also suggested alternatives such as allowing the borrower to disclose to HUD, on an annual basis, payments of project funds to principals, and in return be subject to a HUD audit. The commenters stated that, through a sampling audit process, HUD could make a test of reasonableness. Commenters also stated that HUD could develop, with industry participation, standards that must be met if a borrower pays a salary to a principal. For example, the requirement could be revised so that: (1) the borrower can pay salaries and payments to its officers and other employees who do not have a controlling interest in the borrower and to

affiliates providing ancillary services; and (2) such salaries and payments will not be deemed a distribution that will be subject to repayment.

HUD Response: As noted earlier in this preamble, the final rule removes this section. Inasmuch as many owners and operators are related entities, HUD recognizes that it is not uncommon for a borrower principal to be retained by one of those entities and, as proposed, this provision would have required HUD approval in each instance in which a borrower principal works in a compensated position for the owner or operator entity. New § 232.1007 in this final rule requires that operating expenses be reasonable. In light of inclusion of this new section, HUD has determined that the proposed § 232.1009 is unnecessary.

Financial reports (§ 232.1009 in final rule)

This new section, which was § 232.1011 at the proposed rule stage, clarifies and reorganizes the borrower's financial reporting requirements by placing them in part 232 of HUD's regulations. As has long been required, the borrower must submit audited financial statements, prepared and certified in accordance with the requirements of 24 CFR 5.801 and 24 CFR 200.36. The section also requires the operator to provide HUD with complete quarterly and year-to-date financial reports based on an examination of the books and records of the operator's operations with respect to the healthcare facility.

Comment: Allow borrowers to submit income statements and balance sheets in the borrowers' format rather than audited financial statements. A commenter stated that this requirement should be limited to income statements and balance sheets, since most long-term care financial accounting software packages do not contain a statement of cash flows report. In addition, the commenter stated that these reports should follow the borrowers' format so that an

additional administrative and bookkeeping burden of reformatting financial statements into HUD's format is not imposed.

HUD Response: HUD appreciates the comment, but declines to adopt the commenter's recommendations. However, HUD has determined that it is not necessary to include operational-level instructions on this particular issue at the rule level.

Leases (§ 232.1013 in proposed rule - removed in final rule)

The proposed rule provided that, except as provided in residential agreements in the normal course of business, an operator may not lease or sublease any portion of the project without HUD's prior written approval.

Comment: Prohibition on leasing or subleasing is unnecessary; HUD already has the right to approve bed reductions. A commenter stated that the proposed policy is unnecessary since HUD already has the right to approve bed reductions. The commenter stated that since beds are the underlying purpose for HUD's involvement in guaranteeing loans for nursing homes, HUD should be concerned only with bed reductions.

Other commenters suggested that this provision should be removed, as it is handled in the transactional documents. The commenters also suggested revisions to add flexibility to the regulations.

HUD Response: As noted earlier in this preamble, the final rule removes this section. HUD agrees that the section was overly broad.

Management agents (§ 232.1011 in final rule)

The proposed rule, at § 232.1015 (now § 232.1011 in this final rule), provides that an operator may, with the prior written approval of HUD, execute a management agent agreement setting forth the duties and procedures for managing matters related to the project. The proposed

rule also provided that both the management agent and the management agent agreement must be acceptable to HUD and approved in writing by HUD. The proposed rule further provided that an operator may not enter into any agreement that provides for a management agent to have rights to or claims on funds owed to the operator.

Comment: HUD approval of a management agent should be limited and further defining details should be included. A commenter stated that this policy should be limited to situations where an individual state does not already regulate management agreements and impose licensure on management companies. A commenter stated that HUD could consider retaining the restriction on renegotiation of management agreements only where there is an identity of interest between the operator/owner and the management agent; otherwise, the financial interest might be blurred or there might be other interests competing against the best interest of the project operations and HUD's interest.

Several commenters stated that a management agent should be defined by its responsibilities as someone who: (1) manages a facility that is not leased; (2) contracts in its own name with the residents; and (3) is the sole entity named on the license for the facility.

HUD Response: As noted earlier in this preamble, the final rule revises this section, accepting the commenters' recommendations in part. In many Section 232 program facilities, there is no management agent entity other than the owner or operator entity itself. However, when management authority is delegated to another entity (agent) via a management agreement, that agent's performance can greatly affect mortgage risk. For this reason, HUD finds it necessary to require HUD approval of a management agent and management agreement prior to a management agent being retained. Accordingly, paragraphs (a) and (b) are retained in § 232.1011 of the final rule. However, paragraphs (c) and (d) are being removed; those paragraphs

relate to reasonableness of expenses, a topic addressed in § 232.1007. HUD has determined that further direction on creating/altering that contractual relationship can more appropriately be addressed, if necessary, as issues arise.

HUD recognizes that the scope of contractual responsibilities of management agents varies among facilities, as pointed out in the commenters' recommendations for further details on the definition of a management agent by activity. Notwithstanding this recognition, HUD does not believe it is prudent to attempt to limit the scope of the provision to the criteria suggested. The criteria stated by the commenters suggest that HUD need approve a management agent only when it is essentially functioning as a licensed operator. However, HUD believes that, even when the management agent is not a licensed entity, the scope of responsibilities undertaken have the potential to directly and significantly impact the financial and operational viability of a facility. Although HUD determined that further direction is not needed in regulation, HUD recognizes that operators use a variety of consultants and task-specific contractors. HUD does not anticipate deeming entities with such limited roles and lacking management decision-making authority as "management agents."

Restrictions on deposit, withdrawal, and distribution of funds, and repayment of advances (§ 232.1013 in final rule)

Section 232.1017 in the proposed rule (now § 232.1013 in the final rule) directed, in paragraph (a), that an operator must deposit in a separate segregated account in the project's name all revenue that the operator receives from operating the healthcare facility, and that the account must be with a financial institution whose deposits are insured by an agency of the Federal Government, provided that, in order to minimize risk to the insurance fund, where

balances are likely to exceed federal limits on insurance of such deposits, funds must be in depository institutions acceptable to Ginnie Mae.

Paragraph (b) of proposed § 232.1017 provided that operators, whether owner-operators or non-owner-operators, must ensure that the healthcare facility maintains positive working capital at all times.

The following comments submitted in response to proposed § 232.1017, as seen below, raised issues the same or similar to those comments submitted on proposed § 232.254.

Comment: Revise definition of working capital to recognize project cash flow and make the requirement subject to HUD discretion. Commenters stated that this requirement to maintain working capital at all times is not possible since operators must pay accounts payable and pay employees more quickly than it receives payment from payor sources including Medicaid. The commenters stated that in order to properly cash-flow the business, borrowers often enter into accounts receivable-secured working capital loans.

A commenter stated that in a typical accounts-receivable financing arrangement involving more than one project, funds received by the operator may be deposited in a lockbox in the name of the AR lender, which is not a separate, segregated account. Therefore, the commenter suggested that flexibility be built into the rule to allow HUD to approve other arrangements with respect to the deposit of funds.

Other commenters stated that HUD should provide a definition of positive working capital that accounts for these timing differences.

A commenter stated that HUD should amend this requirement to state that the operator maintain working capital as HUD may prescribe. The commenter recommended that HUD more comprehensively address the issue of working capital in a handbook.

HUD Response: HUD is accepting the commenter's recommendations and modifying proposed § 232.1017(b) to read as follows: "If a quarterly/year-to-date financial statement demonstrates negative working capital as defined by HUD, or if the operator fails to timely submit such statement, then until a current quarterly/year-to-date financial statement demonstrates positive working capital or until otherwise authorized by HUD, the operator may not distribute, advance, or otherwise use funds attributable to that facility for any purpose other than operating that facility."

As noted in a response to earlier comments about working capital, HUD will address working capital for Section 232 projects (including modifications, if any, to the definition as understood through Generally Accepted Accounting Principles (GAAP) as issues arise.

Prompt notification to HUD and mortgagee of circumstances placing the value of the security at risk (§ 232.1015 in final rule)

The proposed rule, at § 232.1019 (now § 232.1015 in the final rule) would have required operators, unless HUD determines otherwise, to promptly notify the owner, mortgagee, and HUD of certain matters placing the facility's viable operation, and thus the mortgage security, at substantial risk. These matters include violations of permits and approvals, imposition of civil money penalties, or governmental investigations or inquiries involving fraud. In the proposed rule, HUD determined that, given the responsibilities of servicing lenders with respect to risk mitigation of their residential care facility portfolio, it is appropriate that the lenders are timely provided with the same financial, census, and performance data (of the owner entity, as well as operator entity) that HUD is requiring borrowers and operators to routinely provide to HUD. Accordingly, the proposed rule provided that, concurrently with submitting to HUD financial

data and census and performance data, the borrower and operator also provide this data to the servicing lender.

Comment: Limit scope of required notification. A commenter stated that a 48-hour requirement to forward notification of receipt of a notification is too short a time period for delivery of electronic copies of notices, reports, surveys, etc., which contain information relating to potential risks to the value of the security. The commenter noted that if, for example, notice of a permit violation was received at 4:00 p.m. on a Friday, under the proposed rules notice would need to be provided to HUD by 4:00 p.m. on Sunday. The commenter suggested that there is no need to specify a time period. Therefore, the commenter stated that revising § 232.1019(a)(1)(i) to replace "within 48 hours after the date of receipt" with "within such time period as may be prescribed by HUD." Additionally, the commenter suggested that the phrase "Such required information shall include" should be replaced with "Such required information may include", so that if HUD determines that this provision is generating information that HUD does not want or need (for example, notice of termination of a permit that is no longer necessary), HUD can easily alter the delivery requirements based on criteria other than severity.

The commenter submitted that delivery of evidence of permit violations should be required only if the permits that are the subject of violations relate to the operation of the facility. Similarly, the commenter stated that notices of a civil money penalty being imposed should be required to be provided to HUD only if the violations that are the subject of the notices relate to the healthcare facility. Otherwise, HUD resources would be unnecessarily expended reviewing violations of permits and civil money penalties unrelated to the operation of the HUD-insured facility.

HUD Response: HUD adopts the recommendations in part. HUD is retaining the requirement that the notices listed in the rule must be provided to HUD in order to allow HUD to ascertain financial risks to the facility. The rule continues to provide that the response time will be 2 business days of receipt, which HUD continues to maintain is a generally reasonable response time, but the final rule allows HUD to approve a longer period for response.

HUD adopted the commenters' recommendation to limit the transmittal of information related to the facility, since HUD's primary interest is with regard to the facility insured. Additionally, § 232.1015 provides that HUD may determine that certain information shall be exempt from the reporting requirement based on severity level.

Comment: Make the notification requirement prospective. A commenter stated that as drafted, § 232.1019(b), now § 232.1015 in the final rule, would apply the notification requirements to all operators, including operators of existing insured projects, who would not be subject to these requirements under the terms of the mortgage loan transaction documents and regulations in effect at the time the loan closed. The commenter stated that they believed that the requirements of any new regulation should apply only to those projects that are subject to the new Section 232 loan documents, and which received a firm commitment on or after the effective date of the final regulations.

HUD Response: HUD declines to adopt the commenters' recommendation. HUD included this provision in the proposed rule in order to assure that both HUD and the lender would be notified of notices affecting both properties already in the HUD portfolio and properties insured after the effective date of the rule. Receipt of these notices will help HUD monitor failure to comply with government requirements. To the extent these notices serve as

potential indicators of financial and/or management problems, they provide HUD and the lender with valuable information.

III. Costs and Benefits of Revisions to the Section 232 Program Regulations

As discussed in this preamble, this final rule updates HUD's Section 232 program regulations similar to the 2011 updates that were made to HUD's multifamily rental project regulations and accompanying closing documents. The revisions made by this rule update the Section 232 regulations to reflect existing practices in financing and refinancing healthcare facilities, and to decrease risk to the program due to outdated regulations and the need for greater accountability by healthcare facility operators. Key changes highlighted in the preamble include reducing duplicative physical inspections, extending the time period for the process of assigning the mortgage to HUD to provide an opportunity for the parties to effectuate a workout, and requiring operators to submit quarterly and year-to-date self-certified financial reports. HUD makes two significant changes at this final rule stage. First, HUD removes the across-the-board requirement for borrowers to establish a long-term debt service reserve. The final rule provides that HUD will impose this requirement only when underwriting determines there is an atypical project risk. Second, HUD removes the requirement to segregate accounts for the purpose of isolating a particular healthcare facility's financial transactions from an account where the facility's funds have been commingled with funds of other facilities. HUD was persuaded by the comments that advised that software today is sophisticated and can provide the protections that HUD sought from proposing the manual segregation of funds.

The valued benefits from fewer physical inspections and the costs from increased financial reporting, together with the opportunity cost of the debt service reserve fund, where such fund is required, each total less than \$1 million. Unvalued benefits include uninterrupted

services of healthcare facilities, which otherwise would close due to foreclosure. Transfers from avoided claim payments total \$13 million. The total costs, benefits, and transfers of this rule will not in any year exceed the \$100 million threshold set by Executive Order 12866 (Regulatory Planning and Review). Therefore, the rule is not economically significant.

The risk mitigation requirements addressed by this rule are necessary due to the combination of two particular risks facing healthcare facilities. First, similar to multifamily residential properties, the owner usually relies on a separate entity to operate the facility. Second, unlike residential or other commercial properties, the value of a poorly maintained and operated facility can decrease dramatically because the building was designed specifically for healthcare use and, if its use for the purpose is jeopardized, it may not retain the mortgaged value at resale due to a lack of alternative uses. Thus, FHA may face more uncertainty when selling foreclosed healthcare properties than foreclosed residential properties. This final rule therefore retains requirements, proposed by the May 3, 2012, rule, that are intended to identify operator deficiencies earlier and ensure that funds are available if financial problems arise.

As noted earlier, this final rule, unlike the proposed rule, will not require all borrowers to establish a long-term debt service reserve fund. Instead, the final rule gives HUD the discretion to impose this requirement when underwriting reflects an atypical long-term project risk. The final rule retains the greater flexibility proposed to be provided to borrowers by the May 3, 2012, rule, in the making of distributions and use of surplus cash.

As did the proposed rule, the final rule requires operators to submit annual and year-to-date financial reports. Currently, the borrower, but not the operator, is required to provide audited financial statements. Although submission of the operator's financial reports is a new requirement, the expense of such reports is mitigated by allowing the operator to submit self-

certified, rather than audited statements. Moreover, the required operator financial information is data that operators need to maintain in the normal course of business in order to monitor and manage their own operations effectively. FHA estimates this will require approximately 10,000 employee hours annually to prepare and submit these reports (2,500 respondents, 4 reports per year and 1 hour to generate each report). The median wage of the employees who prepare these reports is approximately \$75 per hour. Thus, the total cost of complying with this requirement would be \$750,000.

Finally, this rule, as proposed by the May 3, 2012, rule, exempts facilities from FHA physical inspection requirements if they are inspected by State or local agencies, so as to eliminate duplicative inspections. FHA estimates that, as a result, approximately 1,391 inspections would be avoided per year. The estimated cost per inspection totals \$475, which would mean a total annual inspection savings of \$660,725.

In addition to the valued benefits, this rule also provides benefits that are less easily quantified. As explained above, HUD expects the establishment of the reserve fund, where high risk triggers the need for such a fund, and financial reporting requirements to decrease the number of claims paid. While some troubled facilities may be stabilized and continue operating, at that stage of delinquency, they are often forced to close. Thus, there is a disruption of healthcare services to the community and the imposition of costs to move residents from one facility to another. In smaller communities, there are fewer alternatives for facility residents, and the benefits of avoiding foreclosure are greater as residents may be without needed services for a long period. In larger cities, existing facilities may be able to absorb the additional demand fairly quickly. In both of these cases, however, residents bear costs associated with transferring between facilities. Although the avoided loss or interruption of services is difficult to quantify

and varies by city, the avoided loss or interruption of services is an important benefit that this rule is trying to achieve.

IV. Findings and Certifications

Executive Order 13563, Regulatory Review

The President's Executive Order (EO) 13563, entitled "Improving Regulation and Regulatory Review," was signed by the President on January 18, 2011, and published on January 21, 2011, at 76 FR 3821. This EO requires executive agencies to analyze regulations that are "outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned." Section 4 of the EO, entitled "Flexible Approaches," provides, in relevant part, that where relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law, each agency shall identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public. As discussed earlier in this preamble, the regulations governing the Section 232 program facilities have not been updated since 1996. HUD submits that the changes by this rule to the Section 232 regulations are consistent with the EO's directions. As previously discussed, the changes in this rule will modernize the Section 232 program, reduce burden by eliminating duplicative physical inspections, providing flexibility to borrowers in the making of distributions and use of surplus cash, and increasing accountability to strengthen the program, thereby helping it ensure that it remains viable for the financing of healthcare facilities.

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 et seq.) generally requires an agency to conduct a regulatory flexibility analysis of any rule subject to notice and comment rulemaking

requirements, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.

This rule is directed to creating transparency in HUD's Section 232 program by codifying existing and longstanding provisions imposed on a Section 232 program borrower, and strengthening this program through stronger risk management practices, such as making operators more accountable for their role in administering Section 232 healthcare facilities. As noted under the discussion of EO 13563, this rule enhances HUD's oversight ability, while minimizing the burdens on private actors, to the benefit of participants and facility clients. Additionally, by clarifying and codifying existing requirements, the rule makes it easier for borrowers and operators to comply with their legal obligations. Through this rule, the viability of the Section 232 program and HUD's enforcement authority are increased, and waste, fraud, and abuse are reduced.

Approximately 3,343 of the anticipated annual participants in the Section 232 program are small entities, including approximately 2,500 entities involved in nursing homes, 725 entities involved in assisted-living facilities, and 70 other entities. (The total figure exceeds the number of facilities involved, because a single transaction may involve distinct legal entities serving as the operator and owner.) The changes required by this rule do not impose significant economic impacts on these small entities or otherwise adversely disproportionately burden such small entities. The reporting requirements of this rule have been tailored to complement normal business accounting practices. Accordingly, the undersigned certifies that this rule will not have a significant economic impact on a substantial number of small entities.

Environmental Impact

A Finding of No Significant Impact with respect to the environment for this rule was made at the proposed rule stage in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)). That Finding of No Significant Impact remains applicable to this final rule and is available for public inspection between the hours of 8 a.m. and 5 p.m. weekdays in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, and 451 Seventh Street, SW, Room 10276, Washington, DC 20410-0500. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the finding by calling the Regulations Division at 202-402-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Relay Service at 800-877-8339.

Executive Order 13132, Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either: (1) imposes substantial direct compliance costs on State and local governments and is not required by statute, or (2) preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule will not have federalism implications and would not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C.1531-1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and on the private sector. This rule does not impose any

federal mandates on any state, local, or tribal governments, or on the private sector, within the meaning of UMRA.

Information Collection Requirements

The information collection requirements contained in this rule were reviewed by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520), and assigned OMB Control Numbers 2502-0427, 2502-0593, and 2502-0551. In accordance with the Paperwork Reduction Act, an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless the collection displays a currently valid OMB control number.

The docket file is available for public inspection.

Catalogue of Federal Domestic Assistance

The Catalogue of Federal Domestic Assistance Number for the Mortgage Insurance Nursing Homes, Intermediate Care Facilities, Board and Care Homes and Assisted Living Facilities mortgage insurance programs is 14.129.

List of Subjects

24 CFR Part 5

Administrative practice and procedure, Aged, Claims, Grant programs-housing and community development, Individuals with disabilities, Intergovernmental relations, Loan programs-housing and community development, Low and moderate income housing, Mortgage insurance, Penalties, Pets, Public housing, Rent subsidies, Reporting and recordkeeping requirements, Social security, Unemployment compensation, Wages.

24 CFR Part 200

Administrative practice and procedure, Claims, Equal employment opportunity, Fair housing, Home improvement, Housing standards, Lead poisoning, Loan programs—housing and community development, Mortgage insurance, Organization and functions (Government agencies), Penalties, Reporting and recordkeeping.

24 CFR Part 207

Mortgage Insurance-Nursing Homes, Intermediate Care Facilities, Board and Care Homes, and Assisted Living Facilities.

24 CFR Part 232

Fire prevention, Health facilities, Loan programs-health, Loan programs-housing and community development, Mortgage insurance, Nursing homes, Reporting and recordkeeping requirements.

Accordingly, parts 5, 200, 207, and 232 of title 24 of the Code of Federal Regulations are amended as follows:

PART 5 -- GENERAL HUD PROGRAM REQUIREMENTS; WAIVERS

1. The authority citation for 24 CFR part 5 continues to read as follows:

Authority: 42 U.S.C. 1437a, 1437c, 1437d, 1437f, 1437n, 3535(d), and Sec. 327, Pub. L. 109-115, 119 Stat. 2936.

2. Amend § 5.801 by:

- a. Adding paragraph (a)(6),
- b. Revising the first sentence of the introductory text of paragraph (b),
- c. Adding paragraph (b)(4),

d. Revising the paragraph (c) subject heading,

e. Adding paragraph (c)(4), and

f. Adding paragraph (d)(4) to read as follows:

§ 5.801 Uniform financial reporting standards.

(a) * * *

(6) Operators of projects with mortgages insured or held by HUD under section 232 of the Act (Mortgage Insurance for Nursing Homes, Intermediate Care Facilities, Board and Care Homes).

(b) Submission of financial information. Entities (or individuals) to which this subpart is applicable must provide to HUD such financial information as required by HUD. Such information must be provided on an annual basis, except as required more frequently under paragraph (c)(4) of this section. This information must be:

* * * * *

(4) With respect to financial reports relating to properties insured under section 232 of the Act, concurrently with submitting the information to HUD, submitted to the mortgagee in a format and manner prescribed and/or approved by HUD.

(c) Filing of financial reports. * * *

* * * * *

(4) For entities listed in paragraph (a)(6) of this section, the financial information to be submitted to HUD in accordance with paragraph (b) of this section must be submitted to HUD on a quarterly and fiscal-year-to-date basis, within 30 calendar days of the end of each quarterly reporting period, except that the final fiscal-year-end quarter and fiscal-year-to-date reports must be submitted to HUD within 60 calendar days of the end of the fiscal-year-end quarter. HUD

may direct that such forms be submitted to the lender or another third party in addition to or in lieu of submission to HUD.

(i) The financial statements submitted by entities listed in paragraph (a)(6) of this section may, at the operator's option, be operator-certified rather than audited, provided, however, if the operator is also the borrower, then that entity's obligation to submit an annual audited financial statement (in addition to its obligation as an operator to submit financial information on a quarterly and year-to-date basis) remains and is not obviated.

(ii) If HUD has reason to believe that a particular operator's operator-certified statements may be unreliable (for example, indicate a likely prohibited use of project funds), or are presented in a manner that is inconsistent with Generally Accepted Accounting Principles, HUD may, on a case-by-case basis, require audited financial statements from the operator. With respect to facilities with FHA-insured or HUD-held Section 232 mortgages, HUD may request more frequent financial statements from the borrower and/or the operator on a case-by-case basis when the circumstances warrant. Nothing in this section limits HUD's ability to obtain further or more frequent information when appropriate pursuant to the applicable regulatory agreement.

(d) * * *

(4) Entities described in paragraph (a)(6) of this section must comply with the requirements of this section with respect to fiscal years commencing on or after the date that is 60 calendar days after the date on which HUD announces, through Federal Register notice, that it has issued guidance on the manner in which these reports will be transmitted to HUD.

* * * * *

PART 200 – INTRODUCTION TO FHA PROGRAMS

3. The authority citation for part 200 continues to read as follows:

Authority: 12 U.S.C. 1702-1715-z-21; 42 U.S.C. 3535(d).

4. In 200.855, add paragraph (c)(5) to read as follows:

§ 200.855 Physical condition standards and physical inspection requirements.

* * * *

(c) * * *

(5)(i) For assisted-living facilities, board and care facilities, and intermediate care facilities, the initial inspection required under this subpart will be conducted within the same time restrictions set forth in paragraph (c)(4) of this section, and any further inspections will be conducted at a frequency determined consistent with § 200.857, except that HUD may exempt such facilities from physical inspections under this part if HUD determines that the State or local government has a reliable and adequate inspection system in place, with the results of the inspection being readily and timely available to HUD; and

(ii) For any other Section 232 facilities, the inspection will be conducted only when and if HUD determines, on the basis of information received, such as through a complaint, site inspection, or referral by a State agency, on a case-by-case basis, that inspection of a particular facility is needed to assure protection of the residents or the adequate preservation of the project.

PART 207 – MULTIFAMILY HOUSING MORTGAGE INSURANCE

5. The authority citation for part 207 continues to read as follows:

Authority: 12 U.S.C. 1701z-11(e), 1713, and 1715b; 42 U.S.C. 3535(d).

6. In § 207.255: remove, in paragraph (a)(4) introductory text, the reference to “paragraph (b)” and add in its place a reference to “paragraph (a)”; revise paragraph (b)(4) introductory text; and add paragraph (b)(5) to read as follows:

§ 207.255 Defaults for purposes of insurance claim.

* * * * *

(b) * * *

(4) Except for mortgages insured under section 232 of the Act, for the purposes of paragraph (b) of this section, the date of default shall be considered as:

* * * * *

(5) For mortgages insured under section 232 of the Act, for purposes of this section, the date of default shall be considered as:

(i) The first date on which the borrower has failed to pay the debt when due as a result of the lender’s acceleration of the debt because of the borrower’s uncorrected failure to perform a covenant or obligation under the regulatory agreement or security instrument; or

(ii) The date of the first failure to make a monthly payment that subsequent payments by the borrower are insufficient to cover when applied to the overdue monthly payments in the order in which they become due.

7. Amend § 207.258 by:

a. Revising paragraphs (a)(1) and (a)(2) introductory text;

b. Adding paragraph (a)(4); and

c. Revise paragraph (b)(1)(i).

The revisions and addition read as follows:

§ 207.258 Insurance claim requirements.

(a) Alternative election by mortgagee. (1) When the mortgagee becomes eligible to receive mortgage insurance benefits pursuant to § 207.255(a)(3) or (b)(3), the mortgagee must, within 45 calendar days after the date of eligibility, such period is referred to as the “Eligibility Notice Period” for purposes of this section, give the Commissioner notice of its intention to file an insurance claim and of its election either to assign the mortgage to the Commissioner, as provided in paragraph (b) of this section, or to acquire and convey title to the Commissioner, as provided in paragraph (c) of this section. Notice of this election must be provided to the Commissioner in the manner prescribed in 24 CFR part 200, subpart B. HUD may extend the Eligibility Notice Period at the request of the mortgagee under the following conditions:

(i) The request must be made to and approved by HUD prior to the 45th day after the date of eligibility; and

(ii) The approval of an extension shall in no way prejudice the mortgagee's right to file its notice of its intention to file an insurance claim and of its election either to assign the mortgage to the Commissioner or to acquire and convey title to the Commissioner within the 45-day period or any extension prescribed by the Commissioner.

(2) For mortgages funded with the proceeds of state or local bonds, Ginnie Mae mortgage-backed securities, participation certificates, or other bond obligations specified by the Commissioner (such as an agreement under which the insured mortgagee has obtained the mortgage funds from third-party investors and has agreed in writing to repay such investors at a stated interest rate and in accordance with a fixed repayment schedule), any of which contains a lock-out or prepayment premium, in the event of a default during the term of the prepayment lock-out or prepayment premium, and for any mortgage insured under section 232 of the Act, the mortgagee must:

* * * * *

(4) Acknowledgment of election. For mortgages insured pursuant to section 232 of the Act, if the lender provides notice to the Commissioner of its election either to assign the mortgage to the Commissioner or to acquire and convey title to the Commissioner, the Commissioner shall, not later than 90 calendar days after the expiration of the Eligibility Notice Period, as defined in paragraph (a)(1) of this section, as the same may have been extended, acknowledge and accept, or reject for cause, pursuant to program requirements, the lender's election, provided that the Commissioner may, in the Commissioner's discretion, extend such 90-day period by no more than an additional 90 calendar days if the Commissioner determines that such an extension is in HUD's interest.

(b)* * *

(1)* * *

(i) If the mortgagee elects to assign the mortgage to the Commissioner, the mortgagee shall, at any time within 30 calendar days after the date HUD acknowledges the notice of election, file its application for insurance benefits and assign to the Commissioner, in such manner as the Commissioner may require, any applicable credit instrument and the realty and chattel security instruments.

* * * * *

PART 232 – MORTGAGE INSURANCE FOR NURSING HOMES, INTERMEDIATE CARE FACILITIES, BOARD AND CARE HOMES, AND ASSISTED LIVING FACILITIES

8. The authority citation for 24 CFR part 232 continues to read as follows:

Authority: 12 U.S.C. 1715b, 1715w; 42 U.S.C. 3535(d).

9. Throughout part 232, the word “mortgagor” is revised to read “borrower” wherever it appears.

10. Revise § 232.1 to read as follows:

§ 232.1 Eligibility requirements, generally; applicability of certain requirements.

(a) Eligibility, generally. All of the requirements set forth in 24 CFR part 200, subpart A, except for the requirements for “eligible mortgagor” in 24 CFR 200.5, apply to mortgages insured under section 232 of the National Housing Act (12 U.S.C. 1715w), as amended.

(b) Applicability of certain requirements. As of [**insert date 30 days after date of publication in the Federal Register**] the provisions in 24 CFR 207.255(b)(5), 207.258, 232.3, 232.11, 232.254, 232.903(c) and (d), and subpart F of part 232, excluding §§ 232.1007, 232.1009, and 232.1015 of subpart F are applicable only to transactions for which a firm commitment has been issued under this part on or after April 9, 2013.

§ 232.3 [Redesignated as § 232.7]

11. In subpart A, redesignate § 232.3 as § 232.7 and add a new § 232.3 to read as follows:

§ 232.3 Eligible borrower.

The borrower shall be a single asset entity acceptable to the Commissioner, as may be limited by the applicable section of the Act, and shall possess the powers necessary and incidental to owning the project, except that the Commissioner may approve a non-single asset borrower entity under such circumstances, terms, and conditions determined and specified as acceptable to the Commissioner.

12. Add § 232.11 to subpart A to read as follows:

§ 232.11 Establishment and maintenance of long-term debt service reserve account.

(a) To be eligible for insurance under this part, and except with respect to Supplemental Loans to Finance Purchase and Installation of Fire Safety Equipment (subpart C of this part), if HUD determines the mortgage presents an atypical long-term risk, HUD may require that the borrower establish, at final closing and maintain throughout the term of the mortgage, a long-term debt service reserve account.

(b) The long-term debt service reserve account, if required, may be financed as part of the initial mortgage amount, provided that the maximum mortgage amount as otherwise calculated is not thereby exceeded.

(c) The amount required to be initially placed in the long-term debt service reserve account and the minimum long-term balance to be maintained in that account will be determined during underwriting and separately identified in the firm commitment. Although HUD may, when appropriate to avert a mortgage insurance claim, permit the balance to fall below the required minimum long-term balance, the borrower may not take any distribution of mortgaged property except when both the long-term debt service reserve account is funded at the minimal long-term level and such distribution is otherwise permissible.

13. Add § 232.254 to subpart B to read as follows:

§ 232.254 Withdrawal of project funds, including for repayments of advances from the borrower, operator, or management agent.

Borrower may make and take distributions of mortgaged property, as set forth in the mortgage loan transactional documents, to the extent and as permitted by the law of the applicable jurisdiction, provided that, upon each calculation of borrower surplus cash (as defined by HUD), which calculation shall be made no less frequently than semi-annually, borrower must demonstrate positive surplus cash, or to the extent surplus cash is negative, repay any

distributions taken during such calculation period within 30 calendar days unless a longer time period is approved by HUD. Borrower shall be deemed to have taken distributions to the extent that surplus cash is negative unless, in conjunction with the calculation of surplus cash, borrower provides to HUD documentation evidencing, to HUD's reasonable satisfaction, a lesser amount of total distributions. To the extent that the provisions of this section are inconsistent with the provisions in a borrower's existing transactional loan documents, including without limitation any HUD-required regulatory agreement, the provisions of the transactional loan documents shall apply.

14. In § 232.903, revise the introductory text and paragraphs (c) and (d) to read as follows:

§ 232.903 Maximum mortgage limitations.

Notwithstanding the maximum mortgage limitations set forth in 24 CFR 200.15, a mortgage within the limits set forth in this section shall be eligible for insurance under this subpart.

* * * * *

(c) Project to be refinanced—additional limit. (1) In addition to meeting the requirements of paragraphs (a) and (b) of this section, if the Project is to be refinanced by the insured mortgage, the maximum mortgage amount must not exceed the cost to refinance the existing indebtedness. For the purposes of this requirement:

- (i) The Project shall not have changed ownership subsequent to the date of application, or
- (ii) The Project shall have been sold to a purchaser who has an identity of interest with the seller (as defined by the Commissioner).

(2) The cost to refinance the existing indebtedness will consist of the following items, the eligibility and amounts of which must be determined by the Commissioner:

- (i) The amount required to pay off the existing indebtedness;
- (ii) The amount of the initial deposit for the reserve fund for replacements;
- (iii) Reasonable and customary legal, organization, title, and recording expenses, including mortgagee fees under § 200.41;
- (iv) The estimated repair costs, if any;
- (v) Architect's and engineer's fees, municipal inspection fees, and any other required professional or inspection fees; and
- (vi) The amount of any long-term debt service reserve account required by the Commissioner pursuant to § 232.11.

(d) Project to be acquired—additional limit. In addition to meeting the requirements of paragraphs (a) and (b) of this section, if the project is to be acquired by the borrower and the purchase price is to be financed with the insured mortgage, the maximum amount must not exceed 85 percent for a profit-motivated borrower and 90 percent for a private nonprofit borrower of the cost of acquisition as determined by the Commissioner. The cost of acquisition shall consist of the following items, to the extent that each item (except for paragraph (d)(1) of this section) is paid by the purchaser separately from the purchase price. The eligibility and amounts of these items must be determined in accordance with standards established by the Commissioner.

- (1) Purchase price is indicated in the purchase agreement;
- (2) An amount for the initial deposit to the reserve fund for replacements;

(3) Reasonable and customary legal, organizational, title, and recording expenses, including mortgagee fees under § 200.41;

(4) The estimated repair cost, if any;

(5) Architect's and engineer's fees, municipal inspection fees, and any other required professional or inspection fees; and

(6) The amount of any long-term debt service reserve account required by the Commissioner pursuant to § 232.11.

15. Add subpart F to read as follows:

Subpart F – Eligible Operators and Facilities and Restrictions on Fund Distributions

Sec.

232.1001	Scope.
232.1003	Eligible operator.
232.1005	Treatment of project operating accounts.
232.1007	Operating expenses.
232.1009	Financial reports.
232.1011	Management agents.
232.1013	Restrictions on deposit, withdrawal, and distribution of funds, and repayment of advances.
232.1015	Prompt notification to HUD and mortgagee of circumstances placing the value of the security at risk.

Subpart F – Eligible Operators and Facilities and Restrictions on Fund Distributions

§ 232.1001 Scope.

This subpart establishes requirements applicable to the operators of healthcare facilities and the facilities under this part.

§ 232.1003 Eligible operator.

Operator shall be a single asset entity acceptable to the Commissioner, and shall possess the powers necessary and incidental to operating the healthcare facility, except that the Commissioner may approve a non-single asset entity under such circumstances, terms, and

conditions determined and specified as acceptable to the Commissioner. A master tenant under a master lease approved by the Commissioner who has subleased the healthcare facility to an operator is not an Operator.

§ 232.1005 Treatment of project operating accounts.

All accounts deriving from the operation of the property, including operator accounts and including all funds received from any source or derived from the operation of the facility, are project assets subject to control under the insured mortgage loan's transactional documents, including, without limitation, the operator's regulatory agreement. Except as otherwise permitted or approved by HUD, funds generated by the operation of the healthcare facility shall be deposited into a federally insured bank account, provided that an account held in an institution acceptable to Ginnie Mae may have a balance that exceeds the amount to which such insurance is limited. Any of the owner's project-related funds shall be deposited into a federally insured bank account in the name of the borrower *provided* that an account held in an institution acceptable to Ginnie Mae may have a balance that exceeds the amount to which such insurance is limited.

§ 232.1007 Operating expenses.

Goods and services purchased or acquired in connection with the project shall be reasonable and necessary for the operation or maintenance of the project, and the costs of such goods and services incurred by the borrower or operator shall not exceed amounts normally paid for such goods or services in the area where the services are rendered or the goods are furnished, except as otherwise permitted or approved by HUD.

§ 232.1009 Financial reports.

The borrower must provide HUD and lender an audited annual financial report based on an examination of its books and records, in such form and substance required by HUD in accordance with 24 CFR 5.801 and 24 CFR 200.36. Operators must submit financial statements quarterly within 30 calendar days of the date of the end of each fiscal quarter, setting forth both quarterly and fiscal year-to-date information, except that the final fiscal year end quarter must be submitted to HUD and lender within 60 calendar days of the end of the quarter, in accordance with 24 CFR 5.801(c)(4).

§ 232.1011 Management agents.

(a) An operator or borrower may, with the prior written approval of HUD, execute a management agent agreement setting forth the duties and procedures for matters related to the management of the project. The management agent, each initial management agent agreement with that agent, and any amendments to such management agent agreements deemed material by the Commissioner must be acceptable to HUD and approved in writing by HUD.

(b) An operator or borrower may not enter into any agreement that provides for a management agent to have rights to or claims on funds owed to the operator.

§ 232.1013 Restrictions on deposit, withdrawal, and distribution of funds, and repayment of advances.

(a) Deposit of funds. An operator must deposit all revenue the operator receives directly or indirectly in connection with the operation of the healthcare facility in an account with a financial institution whose deposits are insured by an agency of the Federal Government, *provided* that an account held in an institution acceptable to Ginnie Mae may have a balance that exceeds the amount to which such insurance is limited.

(b) Withdrawal of funds. If a quarterly/year-to-date financial statement demonstrates negative working capital as defined by HUD, or if the operator fails to timely submit such statement, then until a current quarterly/year-to-date financial statement demonstrates positive working capital or until otherwise authorized by HUD, the operator may not distribute, advance, or otherwise use funds attributable to that facility for any purpose other than operating that facility.

§ 232.1015 Prompt notification to HUD and mortgagee of circumstances placing the value of the security at risk.

(a) HUD and the mortgagee shall be informed of any notification of any failure to comply with governmental requirements including the following:

(1) The licensed operator of a project shall promptly provide HUD and the mortgagee with a copy of any notification that has placed the licensure, a provider funding source, and/or the ability to admit new residents at risk, and any responses to those notices, provided that HUD may determine certain information to be exempt from this requirement based upon severity level. With respect to the requirements of this section:

(i) The operator shall deliver to HUD and the mortgagee electronically, within 2 business days after the date of receipt, unless a longer time period is approved by HUD, copies of any and all notices, reports, surveys, and other correspondence (regardless of form) received by the operator from any governmental authority that includes any statement, finding, or assertion that:

(A) The operator or the project is or may be in violation of (or default under) any of the permits and approvals or any governmental requirements applicable to the operation of the facility;

(B) Any of the permits and approvals is to be terminated, limited in any way, or not renewed;

(C) Any civil money penalty (other than a de minimis amount) is being imposed with respect to the facility; or

(D) The operator or the project is subject to any governmental investigation or inquiry involving fraud.

(ii) The operator shall also deliver to HUD and the mortgagee, simultaneously with delivery to any governmental authority, any and all responses given by or on behalf of the operator to any of the foregoing and shall provide to HUD and the mortgagee, promptly upon request, such additional information relating to any of the foregoing as HUD or the mortgagee may request. The receipt by HUD and/or the mortgagee of notices, reports, surveys, correspondence, and other information shall not in any way impose any obligation or liability on HUD, the mortgagee, or their respective agents, representatives, or designees to take (or refrain from taking) any action; and HUD, the mortgagee, and their respective agents, representatives, and designees shall have no liability for any failure to act thereon or as a result thereof.

(2) The operator shall provide additional and ongoing information as requested by the borrower, mortgagee, or HUD pertaining to matters related to that risk. Controlling documents between or among any of the parties may provide further requirements with respect to such notification and communication.

(b) This section is applicable to all operators as of **[insert date 30 days after publication in the Federal Register]**.

Date: August 31, 2012

Carol J. Galante

Acting Assistant Secretary for Housing –
Federal Housing Commissioner

[FR-5465-F-02]

[FR Doc. 2012-21982 Filed 09/06/2012 at 8:45 am; Publication Date: 09/07/2012]